Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements	**WC Docket No. 02-112**

Reply Declaration

of

LEE L. SELWYN

on behalf of

AT&T Corp.

August 26, 2002

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Introduction

Lee L. Selwyn, of lawful age, declares and says as follows:

1. My name is Lee L. Selwyn; I am President of Economics and Technology, Inc. ("ETI"), Two Center Plaza, Suite 400, Boston, Massachusetts 02108. I submitted a Declaration on behalf of AT&T Corp. on August 5, 2002 in the above-captioned proceeding.

2. In their Comments and accompanying Declarations submitted in this proceeding, the Bell Operating Companies ("BOCs") and their advocacy organization, the United States Telecom Association ("USTA"), contend, generally, that in establishing the three-year "sunset" provision at Section 272(f)(1) of the *Telecommunications Act of 1996* (the "Act") and despite having specifically given the FCC the authority to "extend[] such 3-year period

by rule or order," Congress had actually *intended* that the Section 272 separate affiliate requirement and associated inter-affiliate transaction restrictions and requirement *would expire* at the end of three years barring some "compelling" condition or extraordinary event.[1] Qwest and BellSouth reject the suggestion that the Commission's consideration as to the merits of such an extension should include, among other things, the extent to which a BOC continues to possess and to exercise market power in the local exchange market or the potential harm that BOCs, with the separate affiliate requirement eliminated while maintaining overwhelming local market dominance, may inflict upon competition in the adjacent long distance market.[2] Verizon refers to its losses of local service market share, which have been minimal at best, as somehow providing evidence that their market power has been eroded.[3] They insist that a requirement that they continue to operate their in-region interLATA long distance businesses out of structurally separate affiliates will engender costs and operating inefficiencies that place the BOCs at a competitive disadvantage relative to rival interexchange carriers and that will exceed any benefits that such separation would produce.[4] SBC, Verizon and BellSouth argue that the *Computer III* regime, which eliminated structural

1. BellSouth Comments, at 3, 6, 9; Verizon Comments, at 6.

2. Qwest Comments, at 4; BellSouth Comments, at 15.

3. Verizon Comments, at 6.

4. *Id.*, at 9 and Howard Affidavit; SBC Comments, at 7-8; BellSouth Comments, at 19; Qwest Comments, at 13-14.

separation for BOC customer premises equipment ("CPE") and enhanced services, should apply with equal force in the case of long distance.[5]

3. The purpose of this Reply Declaration is to respond to these various factual claims and to demonstrate that, in addition to being exaggerated and in many instances altogether false, none of the positions being advanced by the BOCs provide a sufficient basis for eliminating or sunsetting the Section 272 separate affiliate requirement at this time.

- First, nothing in the language of the 1996 *Act* or its legislative history limits the scope of the FCC's rulemaking relating to extending the three-year sunset of the Section 272 separate affiliate requirement, nor imposes upon the FCC a requirement that the sunset be extended only upon a finding that a "compelling" or "extraordinary" condition requires such action.

- Second, since the separate affiliate requirement was included in the 1996 *Act* specifically to limit the BOCs' ability, as dominant incumbent local exchange carriers with extensive market power, to discriminate against or otherwise engage in anticompetitive conduct vis-a-vis rival carriers, Section 272 should remain in full force and effect as long as the BOCs continue to possess such market power.

5. Bellsouth Comments, at 5-9; Verizon Comments, at 3-6; SBC Comments, at 19-23.

- Third, despite the relatively small reductions in BOC market shares that have occurred over the past six-plus years, the BOCs remain dominant local exchange carriers within their traditional service footprints, and retain extensive and pervasive market power. The BOCs are no less able today to engage in discriminatory and anticompetitive conduct with respect to rival carriers than they were as of the date of enactment.

- With the separate affiliate requirement in place, the BOCs' Section 272 long distance affiliates confront exactly the same conditions with respect to access to the BOCs' networks as do nonaffiliated interexchange carriers. Contrary to the BOCs' claims, there is no need for the affiliates to construct duplicate network facilities, since access to the BOCs' facilities can be obtained by the affiliate at tariff rates. In contrast, elimination of the Section 272 separate affiliate requirement would afford the (then integrated) BOC long distance business units with enormously superior access to BOC network facilities, re-creating precisely the conditions that led to the 1984 break-up of the former Bell System and undermining competitive activity to the point where remonopolization of the nation's long distance market would become a serious concern.

There has been no diminution in the BOCs' ability to engage in anticompetitive conduct merely as a result of the passage of time, and for that reason the sunset date for the Section 272 separate affiliate requirement should be extended.

Because the BOCs retain extensive market power and market dominance with respect to local exchange and carrier access services, extension of the Section 272 separate affiliate requirements is required in order to protect competition in the long distance market.

4. BellSouth repeatedly advances the "basic premise" that "absent compelling circumstances,"[6] "compelling need[s]"[7] or "compelling reason[s],"[8] Congress contemplated that "a BOC should be relieved of its Section 272 obligations three years after receiving authority to provide in-region, interLATA telecommunications services ..."[9] BellSouth does not offer or cite to any authority in the *Act*, to its legislative history, or to any FCC rulings as support for this contrived "compelling circumstances" standard, nor could it, since no such authority or language is anywhere to be found. With respect to the three-year time frame and the sunset provision, all that the statute says is that the separate affiliate requirement sunsets "unless the Commission extends such three year period by rule or order."[10] Nothing in the *Act* or in its legislative history provides any standards or guidelines that the FCC is to follow in considering whether in fact it should "extend[] such three year period by rule or order." The *Act* simply does not say or imply what BellSouth says it says, *viz.*, that "absent *compelling circumstances*, a BOC should be relieved of its Section 272 obligations three years after receiving authority to provide in-region, interLATA telecommunications services." Indeed,

6. BellSouth Comments, at 9.

7. *Id.*, at 3.

8. *Id.*, at 6.

9. *Id.*, at 3, 6, and 9.

10. 47 C.F.R 272(f)(1).

had Congress intended to limit the scope of the FCC's authority with respect to extending the 272 sunset, it would have included any such restrictions directly in Section 272. In fact, the *Conference Report* indicates that Congress intended a broad scope for the Commission's 272 sunset rulemaking proceeding. When adopting the three year "sunset provisions," the Conference Committee noted that "[i]n any case, the Commission is given authority to extend the separate affiliate requirement by rule or order."[11]

5. Even if the Commission were to accept BellSouth's self-created "premise" that the Commission can only extend the separate affiliate requirements given "compelling reasons," such "compelling reasons" clearly exist. Although both BellSouth and Qwest argue that the facts of local market share are irrelevant to the question of Section 272,[12] this claim ignores the obvious impact of local market power upon competition in the long distance market. Congress enacted Section 272 "in order to check potential market power abuses."[13] In light of this Congressional goal, the contentions of Qwest and BellSouth that market power is irrelevant to this proceeding is absurd. Evidence of market power and market power abuses indicate that the separate affiliate provisions of Section 272, far from being sunset, should be strengthened "by rule or order." If the purpose of enacting Section 272 was "in order to check potential market power abuses," then it is both necessary and entirely appropriate for the Commission, in this proceeding, to determine whether the BOCs still possess market

11. 142 Cong. Rcc. H1118 (January 31, 1996).

12. Qwest Comments, at 5, BellSouth Comments, at 16.

13. 142 Cong. Rcc. H1171 (February 1, 1996).

power and, if they do, that one fact alone provides sufficient basis and justification for extending the sunset date. The presence of pervasive market power and market dominance by the BOCs in the residential and small business local services affords BOCs with:

- The unique ability to leverage that local market power so as to diminish competition in and, ultimately, to remonopolize the adjacent residential/small business long distance market;

- The ability and the incentives to discriminate against competing local and long distance carriers with respect to the provision of essential services; and

- The ability and the incentives to price those essential services and their own retail services in such a way as to create a price squeeze the practical effect of which will be to make effective competition in the retail service market all but impossible.

Evidence of anticompetitive conduct and of the dangers to competition in the interLATA market arising directly as a result of the BOCs' continuing market power is *by itself* fully sufficient to provide the "compelling circumstances" or "compelling reasons" that BellSouth's self-created "standard" for extending the 272 sunset would require.

6. The extraordinarily adverse impact of BOC local market power upon the interLATA market can be readily observed. In those states in which in-region long distance authority has

been granted, the extraordinary rate at which the BOC 272 affiliates have been able to acquire customers and market share is a direct result of the BOCs' market power and the exercise thereof with respect to long distance service. Preemptive use of the "inbound channel" by both Verizon and SBC to "sell" their long distance service to new *local service customers* lies at the core of these two companies' marketing strategy, and in fact has been the principal explanation for their extraordinary success in acquiring customers in the first two years in which they were permitted into the long distance business. Verizon reported that as of the end of 2001, only two years after it began offering long distance service in New York, its long distance affiliate Verizon Long Distance had captured some 2.3-million residential customers in New York,[14] representing a market share of approximately 34.2% of the residential subscribers in Verizon New York's service areas. SBC reported that through the first quarter of 2001, *less than nine months* following its Section 271 entry in Texas, the Company had signed up 21% of its 10-million Texas access lines for SBC long distance.[15] Elsewhere, ten months after receiving 271 authority in Massachusetts, Verizon reported a long distance market share of 17.9%.[16] And Verizon has just announced that in the second quarter of 2002 alone, its long distance customer base has grown by some 800,000.[17]

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14. Verizon Press Release, "Verizon Communications Reports Solid Results for Fourth Quarter, Provides Outlook for 2002," January 31, 2002.

15. *SBC Investor Briefing*, April 23, 2001, at 7.

16. Verizon Press Release, "Verizon Communications Reports Solid 3Q Earnings and Provides Outlook for Remainder of 2001," October 30, 2001.

17. Jane Black, "The Bells' Big Local Headache," *BusinessWeek Online*, August 21, 2002.

7. But for the BOCs' ability to exploit their inbound *local* marketing channel *for the benefit of their long distance affiliate*, there is no *a priori* reason to expect their rate of market share growth to differ materially from that of the OCCs[18] in the initial years following "equal access." Conversely, evidence of substantially greater BOC long distance market share growth serves to confirm the enormous value that BOCs and their interLATA affiliates obtain solely by virtue of their status as dominant local exchange carriers. Without access to the BOCs' legacy customer base, the BOC interLATA affiliates could be expected to gain market share at levels similar to those that had been experienced by the OCCs following the introduction of equal access. By 1989, roughly five years following the completion of BOC equal access upgrades, all of the OCCs combined accounted for only 22.7% of presubscribed lines.[19] Verizon New York was able to surpass that figure in slightly over one year, while it appears that SBC in Texas achieved that same market share in less than one year. And as for the 34.2% share that Verizon achieved after just 24 months following its entry into the New York long distance market, *no single OCC has ever achieved that high a share, even after more than fifteen years following the establishment of "equal access."*

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18. The term "Other Common Carriers" ("OCCs") was used in the period immediately following the 1984 break-up of the former Bell System to refer to interexchange carriers other than AT&T.

19. Federal Communications Commission, Wireline Competition Bureau, Industry Analysis Division, *Long Distance Market Shares, Fourth Quarter 1998*, March, 1999, Table 2.2.

8. The BOCs' unique ability to engage in joint marketing and to benefit uniquely from their legacy relationships with the vast majority of residential and small business local service customers in their effort at acquiring long distance market share has the potential to lead ultimately to BOC remonopolization of the long distance market, at least at the retail residential and small business level. That potential would be exacerbated if the separate affiliate requirement were to be eliminated, because the BOCs would then be in a position to complement their already substantial joint marketing advantage with the additional ability and opportunity to discriminate against competitors in the provision of access and other essential services and the creation of price squeezes between the BOCs' own retail long distance prices and those being charged to rivals for access to the BOCs' networks. Remonopolization will ultimately lead to higher retail long distance prices, potentially costing consumers billions of dollars nationwide. And we won't have to wait for full remonopolization before those rate increases will be initiated. As I noted in my August 5 Declaration at para. 47, "SBC was sufficiently satisfied with its early market performance in Texas that after only seven months the company *increased* its interstate long distance rates by over 10%." Whatever the "costs" of separate affiliates may be — and as I shall discuss below the unsupported figures being advanced by the BOCs here are almost certainly gross exaggerations — the potential harms to competition and consumers arising from BOC remonopolization of retail long distance services more than justify those "costs" on a strictly cost/benefit basis.

9. Qwest itself has recognized and acknowledged this linkage between the existence of BOC local market power and anticompetitive harm to the adjacent long distance market.

Qwest states that the extension of the sunset is unnecessary because the remaining non-structural safeguards will suffice to ensure competition.[20] Qwest notes, however that "[o]f course, once the BOCs cease to have market power, such reporting requirements [of section 272(e)] would no longer be necessary and should be eliminated."[21] Qwest therefore concedes both that it retains local market power *and* that the presence of that market power should have an impact upon the continued application of Section 272 on the BOCs.

10. BellSouth advances the claim, again without citing any support or authority for its position, that

> Congress never intended Section 272 to serve as a market review statute. The relevant criteria for BOC interLATA relief is the opening of the local exchange market to competition. Section 271 with its 14-point checklist is the relevant provision for that analysis, not Section 272.[22]

BellSouth then *leaps* to its unsupported and unsupportable theory that inasmuch as there is no market share or market power test required for Section 271 *entry* authority,[23] there must also be no such market share or market power test with respect to the Section 272 separate affiliate sunset:

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20. Qwest Comments, at 7.

21. *Id.*, at 8, fn. 20.

22. BellSouth Comments, at 15.

23. *Id.*, at 16.

> Given that there is no statutory basis for converting Section 272 into a market analysis statute, the Commission should not — and, in fact, cannot — link the sunset of the Section 272 separate affiliate requirements to the state of local competition in particular markets. That analysis would have already occurred when the Commission granted a BOC authority to offer in-region, interLATA telecommunications services.[24]

Of course, "that analysis" would decidedly *not* "have already occurred when the Commission granted a BOC authority to offer in-region, interLATA telecommunications services" because such an analysis is expressly precluded so long as the 14-point checklist has been satisfied.[25] BellSouth's incredibly circular theory turns the statute on its head: Section 271 does not contain a market power test; hence, as I noted in my August 5 Declaration,[26] there is no basis upon which the Commission can infer from the fact that a BOC has satisfied the 14-point checklist that it no longer has market power. If Congress had believed that a BOC's mere satisfaction of the checklist was by itself sufficient to constrain the BOC's market power, then there would have been no purpose in enacting Section 272 or in giving the FCC the opportunity and authority to extend the sunset date. BellSouth's convoluted reading of Sections 271 and 272 serves only to eviscerate Congress' purpose for including Section 272 in the *Act* by substituting the mere *passage of time* for *actual marketplace facts* as the sole basis for the sunset, BellSouth's analysis is clearly meritless and must be rejected.

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24. *Id.*

25. See, e.g. *Joint Application by BellSouth Corporation, BellSouth Long Distance, Inc. for Provision of In-Region, InterLATA Services in Georgia and Louisiana*, CC Docket No. 02-35, *Memorandum Opinion and Order*, FCC 02-147, at para. 14.

26. Selwyn Declaration, August 5, 2002, at paras. 10-11.

11. Unlike BellSouth and Qwest, Verizon and SBC do seem to accept the validity of an inquiry into a BOC's local market share as probative as to the existence of such a "compelling justification," but of course each then contends that there is now sufficient competition to justify the sunset. Verizon argues that "... competition has flourished. The number of lines served by incumbent local exchange carriers has declined for the last three years running, a trend that has never occurred before in over a century of telephone service."[27] What Verizon does not bother to mention is that a portion of that decline is the result of factors other than competition from CLECs. For example, the *Washington Post* reported last year that:

> A top executive at Verizon Communications Inc. said yesterday that the number of its telephone lines connected to homes and businesses has declined for the first time in the company's history, as consumers cut back on spending or shift to wireless phones and high-speed Internet connections
>
> Ivan Seidenberg, president and co-chief executive of the nation's largest phone company, said the falloff accelerated in the past two months as businesses in particular began to rethink expansion or relocation plans.[28]

A *Wall Street Journal* report reached a similar conclusion — that customers are discontinuing second residential lines and replacing them with wireless phones and high-speed internet

27. Verizon Comments, at 6.

28. "Verizon Records First Drop in Phone Lines; Firm Still Pursuing Voice Services, but Sees Internet as Future, President Says," Yuki Noguchi, *The Washington Post*, September 11, 2001, at E-1.

connections, and specifically that "second lines ... account for most of the recent line loss."[29] The replacement of a second residential access line with a wireless phone and/or a high-speed Internet connection does not signal the kind of "competitive loss" that would indicate a consequential diminution of a BOC's market power with respect to local wireline services. 42% of wireless phones in the US are served by carriers owned or controlled by BOCs.[30] BOCs also serve a substantial share of the residential high-speed Internet access market, so in those cases where customers are discontinuing their second dial-tone line to be replaced by a DSL channel, the BOC will likely experience an *increase* in revenue, certainly not a loss. There is no indication that there has been any decline in the number of *primary* residential access lines — actual *customers* — being served by BOCs. Verizon cites the number of CLEC lines in the FCC's *Local Competition Report*, especially competitive lines in states where the BOCs have been granted section 271 authority, and cites wireless phone substitution as proof of continued developments in competition.[31] SBC states that "... market evidence demonstrates that competition in the local and exchange access markets increases materially after Section

29. "More Callers Cut Off Second Phone Lines for Cellphones, Cable Modems," Shawn Young, *The Wall Street Journal*, November 15, 2001, at B1.

30. *Seventh Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services*, FCC 02-179, Released July 3, 2002, at Table 4.

31. On that particular point, CMRS carriers are subject to lower average access charges on "long distance" calls than are wireline carriers, because they do not pay access charges on calls between the wireless phone (based upon the rating point of its phone number) and any other location within the same Major Trading Area ("MTA"). Hence, the out-of-pocket costs that wireless carriers incur in providing "free" long distance calling are considerably lower than the comparable costs incurred by wireline carriers, particularly by CLECs.

271 authority is granted. The Commission has confirmed that 'states with long distance approval show greatest competitive activity.''"[32]

12. That BOCs, with their overwhelming presence and huge customer penetration within their respective geographic footprints, have market power with respect to local and access services is underscored by the Commission's April 2001 *CLEC Access Charge Order*,[33] in which the Commission concluded that even small CLECs still possess market power with respect to the provision of access to *their own* end-user customers:

> Sprint and AT&T both persuasively characterize both the terminating and the originating access markets as consisting of a series of bottleneck monopolies over access to each individual end user.[34]

On that basis, the Commission established rate caps and other rules respecting such services.[35] If a small CLEC — whose share of the local market is in the low single-digit range or less — has market power with respect to "last mile" access, then it is nothing short of preposterous to suggest that BOCs do not.

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32. SBC Comments, at 16.

33. *In the Matter of Access Charge Reform, Reform of Access Charges Imposed by Competitive Local Exchange Carriers*, CC Docket No. 96-262, *Seventh Report and Order and Further Notice of Proposed Rulemaking*, FCC 01-146, Adopted April 26, 2001, Released April 27, 2001 ("*CLEC Access Charge Order*").

34. *Id.*, at para. 30.

35. *Id.*, at para. 34 *et seq.*

13. In my August 5, 2002 Declaration, I noted that there were in fact a number of states with long distance entry authorization in which there is very little local competition.[36] And, as the FCC has determined with respect to CLECs, the mere fact that the BOC may now have less than a 100% share of the local market does not mean that it no longer has market power. In any event, even if BOCs may be experiencing a slight drop in their share of the retail local service market as they claim, that does not materially change — or diminish — their market power, particularly with respect to essential services and facilities being provided to competing carriers, IXCs and CLECs. And when one compares the small local market share losses being claimed by the BOCs with the massive long distance market share losses being suffered by IXCs in those states in which the BOC has achieved in-region entry, it should be patently clear that the BOC's control and dominance of the local market is not being effectively challenged by such local service competition as may exist at the present time.

The Section 272 separate affiliate today has exactly the same ability to offer its customers bundled and "seamless" end-to-end services as any nonaffiliated IXC, whereas the BOC would acquire an enormous and unchallengeable competitive advantage if allowed to operate its local and long distance businesses on a fully integrated basis.

14. Verizon was alone among the BOCs in providing Declarations in support of its various factual claims. Verizon's Declarant Steven G. McCully testifies as to the handicaps under which he contends Verizon must operate in serving large ("enterprise") customers due to the Section 272(b)(1) "operate independently" requirement and, specifically, the FCC's interpretation of Section 271(b)(1) as referring specifically to Operations, Installation and

36. Selwyn Declaration, August 5, 2002, at paras. 26-27.

Maintenance ("OI&M"). SBC advances similar claims, but without testimonial support.[37] Although Verizon and SBC focus primarily upon large business customers, USTA more generally asserts (but also without advancing any factual or testimonial support) that "... consumers suffer when structural separations are imposed because they cannot obtain competitive packages of bundled services from BOCs, similar to those offered by the BOCs' competitor" and that "[c]onsumers are less willing to purchase local services from a BOC and long distance services from a BOC affiliate when they can purchase both of these services from one provider, the BOC's competitor."[38] These contentions as to what "customers prefer" or what "customers are less willing" to do are offered by the BOCs without any market research or other factual support. Moreover, the enormous success that Verizon and SBC have enjoyed in capturing "consumer" market share specifically by offering "one-stop shopping" for local and long distance clearly belies USTA's unsupported and unsupportable contentions that the presence of the Section 272 structural separation requirement precludes the BOCs from engaging in such "one stop shopping" marketing strategies.

15. Both Verizon and SBC argue that they are particularly handicapped by the OI&M requirements of Section 272(b)(1), basing this claim mainly upon alleged difficulties they encounter in serving large business accounts. SBC asserts, again without factual or testimonial support, that:

37. SBC Comments, at 7-8.

38. USTA Comments, at 7.

> ...if SBC offers a business customer service connecting its Dallas and Houston locations – the SBC BOC cannot, unlike AT&T or some other interexchange carrier, offer one end-to-end serving arrangement to its customer. Rather, SBC offers three different serving arrangements: one intraLATA arrangement from Dallas to the 272 affiliate's point of presence (POP), a second interLATA arrangement that belongs to the 272 affiliate, and a third intraLATA serving arrangement from the 272 affiliate's POP to the Houston location. This arrangement complicates the design and ordering process, as well as coordination and installation for a customer who believes that it is receiving service from a single agent.[39]

and claims that

> ... SBC's customer cannot receive end-to-end testing from either the BOC or the section 272 affiliate. Thus, if the customer calls in with a trouble report, the BOC cannot simply test across the network and determine the problem. Instead, it has to take the following steps: determine whose side of the network has the problem; if the problem is in the long distance network, send a trouble report to the 272 affiliate; give the affiliate time to work out the problem; ask for status updates from the affiliate; and then inform the customer about the status. Any other provider today can take one trouble report, test the circuit across the network, and inform the customer right away of the problem. Although SBC can do end-to-end testing today with other interexchange carriers like AT&T and Sprint to provide their long distance customers with seamless service, the Section 272 restrictions prevent SBC from providing this service to its own customers. These requirements deny consumers one of the fundamental benefits of the Act: the ability to achieve seamless end-to-end service from one provider.[40]

Verizon makes a similar argument:

39. SBC Comments, at 8-9.

40. *Id.*, at 9.

> The OI&M restriction puts Verizon at a significant disadvantage in competing with carriers that are able to offer an integrated service platform using their own local and long distance facilities. For large business accounts, many of Verizon's competitors provide their own transmission facilities directly to the customer's location, seamlessly integrating "local" and "long distance" networks and using a single workforce to respond to installation and repair requests. For example, CLECs use their own fiber-based last-mile facilities to serve the vast majority of their large business customers. *See UNE Fact Report*, p. IV-1. In serving large accounts, Verizon cannot respond as a single team that can maintain end-to-end service. ... The section 272 rules result in a set of hand-offs of customer requests for service and repair that lead to less than optimal results. ... The long distance and BOC work groups must transfer responsibility to each other as they try to verify the location of a problem and resolve it. This hinders Verizon in responding to service issues and in meeting the level of service quality that those customers expect.[41]

However, and specifically with respect to so-called "enterprise services" being provided to large business customers, what is relevant — and what is expressly *not* being claimed by Verizon or supported by the "study" to which it refers — is the percentage of CLEC customer *locations*, not *customers*, that are being served by CLEC-owned facilities. And that percentage — particularly for large, multi-location "enterprise" customers — is likely to be extremely small. So even if "CLECs use their own fiber-based last-mile facilities to serve the vast majority of their large business *customers*" as Verizon claims, Verizon does not cite or

41. Verizon Comments, at 19-20. Citation to *UNE Fact Report* in original. The *UNE Fact Report* to which Verizon refers was prepared for USTA and was submitted by Verizon with its April 5, 2002 Comments in CC Docket 01-338 (*Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*). Significantly, the *UNE Fact Report*, either at the cited Section IV or elsewhere, provides no support for Verizon's assertion that "CLECs use their own fiber-based last-mile facilities to serve the vast majority of their large business customers."

offer any evidence that CLECs use their own fiber-based last-mile facilities to serve the vast majority of their large business *customers' service locations*.

16. The specific competitive challenge being claimed by the BOCs — that their competitors "are able to offer an integrated service platform using their own local and long distance facilities" — exists only in the extremely limited number of individual customer locations at which the BOCs' competitors actually *own* their own local service or other "last mile" network assets. Where the competing IXC or CLEC is ultimately dependent upon BOCs or other ILECs for such facilities, *it is in exactly the same position as a BOC's 272 affiliate in providing "end-to-end service" to a customer*. For example, if an individual "enterprise" customer requires service at one hundred locations in Verizon's operating areas and the largest CLEC owns facilities to only five of them, then in serving that customer the CLEC will still be dependent upon Verizon for 95% of the customer's sites. In those situations, the CLEC has no greater ability to "take one trouble report, test the circuit across the network, and inform the customer right away of the problem" than would the BOC's 272 affiliate purchasing access services or UNEs from the BOC under tariff. Thus, the proper basis for determining exactly who — BOCs or competing carriers — will actually be operating at a competitive disadvantage — and something that none of the BOCs discusses — would be to compare the percentage of customer locations that a BOC would be able to serve end-to-end if the existing Section 272(b)(1) OI&M restriction is permitted to sunset vs. the percentage of customer locations that CLECs are actually today able to serve end-to-end using their own facilities. USTA's *UNE Fact Report* provides no "facts" pertinent to this question.

17. Evidence previously presented to the Commission by AT&T confirms the fact that in the vast majority of cases AT&T must rely upon ILEC-provided loop or entrance facilities to serve its customers:

> AT&T accesses the vast majority of its customers via DS0 (*i.e*. copper pairs), DS1 and DS3 loops leased from the ILEC, to which AT&T connects at collocated space in ILEC central offices.[42]
>
> * * *
>
> With respect to loop facilities to individual buildings, however, it should come as no surprise that alternatives to the ILEC are rarely available. AT&T estimates that there are over 3 million buildings or business locations nationwide. In stark contrast, AT&T has been able to provide direct (*i.e*., non-ILEC) access to slightly more than **[proprietary begin] **** [proprietary end]** buildings. Moreover, where AT&T has built its own facilities into a building, in only about **[proprietary begin]** ********* **[proprietary end]** of cases will AT&T be in a position to use its own facilities to serve all customers in the building that seek service from AT&T. *Bottom line, AT&T reaches only a fraction of a percent of all commercial buildings using non-ILEC facilities and, of those, only a minority are a configuration that provide unrestricted building access using AT&T's own facilities.* Given that ILECs have access to virtually all buildings right now, the situation described hardly supports a finding that reasonable alternatives exist outside the ILEC network and that robust facilities-based competition exists.[43]

42. *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket Nos. 01-339, 96-98, 98-147, Declaration of Michael E. Lesher and Robert J. Frontera on behalf of AT&T Corp., at para. 20.

43. *Id.*, Declaration of Anthony Fea and Anthony Giovannucci on behalf of AT&T Corp., at para. 66, emphasis supplied.

18. Moreover, a study recently conducted and submitted to the Commission by the Ad Hoc Telecommunications Users Committee ("Ad Hoc"), a group of large corporate telecommunications users that participates frequently in FCC proceedings (Ad Hoc members are precisely the type of "enterprise" customer to which Verizon's Declarants refer), confirms AT&T's experience as a competitive service provider while totally undermining the BOCs' claims. In its Comments in CC Docket 01-337, the Commission's *Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Services,* Ad Hoc reports the results of a study of Committee members' use of competing (i.e., non-ILEC) local services, specifically addressing their geographic availability.[44] The Ad Hoc study found that:

> Despite being among the largest and most technologically sophisticated users of telecommunications services in the country, the members of the Ad Hoc Committee report that they face no competitive alternatives to ILEC services to meet their broadband business services requirements in the overwhelming majority of their service locations. Even where competitive alternatives are nominally "available," members are able to make little use of those competitor services, for a variety of reasons.
>
> Committee members aggregated their company-specific information regarding the number of customer locations with broadband service needs falling into each of the four following categories:
>
> - Category A: Capacity of 12 DS-0 channels or less (*i.e.*, ½ T-1, 760 kHz, xDSL, etc.).

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44. *Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Services*, CC Docket No. 01-337, Comments of the Ad Hoc Telecommunications Users Committee, March 1, 2002, at 14-16. The Declarant participated in the drafting of the Ad Hoc Committee's Comments.

- Category B: Capacity of at least one but not more than four DS-1 circuits.

- Category C: Capacity greater than four DS-1 circuits, or at a level sufficient to justify the provision of at least one DS-3 facility, other than SONET or Optical Carrier ("OC") service.

- Category D: SONET or OC service.

Committee members were then asked to provide estimates of the percentage of locations by category for which they were aware of the presence of viable competitive alternatives to ILEC services. Finally, members were asked to estimate the percentage of locations by Category at which they currently used a competitive carrier to satisfy their service requirements. The total number of locations surveyed was about 30,000.

The results of the survey demonstrate that viable competitive alternatives are not frequently available, particularly with respect to smaller business service locations. [*Footnote*: The survey asked respondents to indicate whether there were viable competitive alternatives for each category of service at (a) fewer than 10% of the service locations; (b) between 10% and 25% of the service locations; (c) between 25% and 50% of the service locations; and (d) more than 50% of the service locations.] For the overwhelming majority of Category A and B business service locations, viable competitive alternatives to the incumbent LEC's data service were available at less than 10% of locations. The vast majority of the Category C business service locations also appear to have very few viable competitive alternatives. Although some members indicate the presence of some competitive alternatives for seldom-purchased Category D services, others indicate that viable competitive offerings are no more prevalent for the highest capacity services than for the lowest.

As would be expected, the existence of few viable competitive alternatives has resulted in few actual purchases of competitive data services by Ad Hoc's members. [*Footnote*: The survey asked respondents to indicate whether they purchased data services from competitive carriers for each category of service at (a) fewer than 10% of the service locations; (b) between 10% and 25% of the service locations; (c) between 25% and 50% of the service locations; and (d) more than 50% of the service locations.] Members indicate that in all Category A locations and nearly all Category B locations, fewer than 10% are served by competitors. The majority of Category C and D locations also are served by competitors less than 10% of the time.

Assuming that the members of the Ad Hoc Committee are representative of the large business customers being targeted by Verizon and SBC's "enterprise customer" affiliates, and there is no reason to believe that they are not, with respect to the overwhelming majority of individual service locations, those BOC affiliates are today in exactly the same position as non-BOC IXCs with respect to their need to obtain local access and other local services for such customers from BOCs. By contrast, allowing the OI&M restrictions to sunset would afford the BOCs' "enterprise business" units the unique ability to serve most of their large business customers' locations on a fully integrated basis, which is something that *no IXC or CLEC* is even remotely close to being able to do now or in the foreseeable future.

19. A BOC's Section 272 affiliate, in its capacity as an interexchange carrier, has exactly the same ability to provide both intraLATA and interLATA services to its customers as any non-BOC IXC, such as AT&T or WorldCom. If in the course of doing so the 272 affiliate is required to obtain intraLATA facilities from the BOC's local service entity (e.g., "one intraLATA arrangement from Dallas to the 272 affiliate's point of presence (POP) [and another] ... intraLATA serving arrangement from the 272 affiliate's POP to the Houston location"), *that is no different from what any nonaffiliated IXC would also need to do in order to provide an end-to-end service to a retail customer*. Just as AT&T (as an IXC) can offer its customers end-to-end services by combining access services purchased from BOCs with interexchange network facilities owned by AT&T, so too can the SBC or Verizon 272 affiliate (as an IXC) offer its customers entirely comparable end-to-end services *on an entirely equivalent basis*. Moreover, just as a non-affiliated IXC is *allowed* to own the facilities

interconnecting its customers' premises with its POPs, in which event the IXC can perform full end-to-end testing and provide "seamless" end-to-end services *with respect to those specific circuits*, the BOC 272 affiliate is also "allowed" to own "last mile" facilities, just like any other IXC. The fact set under which the OI&M restriction would place BOCs at a competitive disadvantage is one in which non-BOC carriers owned *extensive*, near-ubiquitous collections of "last mile" assets. Under any other set of market conditions — and it is that "other" set of conditions that actually prevails here — elimination of the OI&M restriction would afford the BOCs a level of competitive advantage as formidable and pervasive as that which led to the break-up of the former Bell System.

20. The local and access market is not competitive, and IXCs not affiliated with BOCs are in the vast majority of cases placed in precisely the same position as are the 272 affiliates with respect to the requirement to purchase access services from BOCs. In fact, if the 272 affiliate is truly operating "at arm's length" vis-a-vis the BOC (as it is required to do pursuant to Section 272(b)(5)), then it would have the same opportunity and incentive to use "competitive" "last mile" facilities where available and where priced below the BOC's tariffed (or non-tariffed) rate.

21. If the requirement for full OI&M separation is eliminated, then the BOC IXC business unit, which would then be integrated into the BOC, would be in a position to — and undoubtedly would — obtain superior access to the intraLATA segments relative to what would be available to nonaffiliated IXCs. As I noted in my Declaration accompanying

AT&T's opening Comments,[45] this is essentially the same situation as has arisen in the case of intraLATA services, where BOCs do not make use of the same "access services and facilities" that are provided to IXCs, thus making the imputation "safeguard" simply not sufficient to protect the IXC from highly discriminatory BOC conduct.

22. Verizon claims that "[t]here is no regulatory need for this [OI&M] restriction."[46] Verizon notes that the Commission was concerned about its ability to ensure that BOCs are correctly allocating costs for services provided to the 272 affiliate, but argues that allocating costs for OI&M functions is no different than allocating costs for the administrative and other services currently provided by the BOC to its affiliate.[47] Verizon contends that the Commission "should eliminate the prohibition on sharing OI&M services immediately for all BOCs regardless of whether the separate affiliate rules have sunset or not in any particular state."[48] In advancing this position, Verizon grossly oversimplifies the reasons for the OI&M restriction as outlined in the *Non-Accounting Safeguards Order* and similarly oversimplifies the cost allocation concern. In that ruling, the Commission concluded that:

> ... allowing the same personnel to perform the operating, installation, and maintenance services associated with a BOC's network and the facilities that a section 272 affiliate owns or leases from a provider other than the BOC would

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45. Selwyn Declaration, August 5, 2002, at paras. 35-36.

46. Verizon Comments, at 17.

47. *Id.*

48. *Id.*, at 21.

> create the opportunity for such substantial integration of operating functions as to preclude independent operation, in violation of section 272(b)(1).[49]

From many years' experience in dealing with BOC provision of *intraLATA* services in competition with IXCs, we now know that in providing such competitive services (and they have been deemed "competitive" and have been detariffed in a number of states), the BOCs do not themselves utilize the same type of "access services" that are provided to competing (nonaffiliated) IXCs. For example, a number of BOC intraLATA toll calls are completed over direct end office-to-end office trunks or through a single tandem. When the same call is routed via an IXC, two separate access tandem connections are almost always required, typically involving additional switching and transport *for which the IXC pays*. BOCs have regularly argued in state PUC imputation proceedings that they should be permitted to impute the cost of the actual facilities they use, not the price that they charge IXCs for the facilities that IXCs use. They have also argued that any such imputation should be made in the aggregate across all categories of interexchange services, not on a service-by-service basis.[50] Under that theory, a particular service could fail imputation so long as another service passed the "imputation test" by an amount sufficient that, taken together, the two in aggregate satisfied the imputation requirement. Thus, the BOC could use profits from intraLATA toll, for example, to cross-subsidize interLATA toll, so long as the two services taken together nominally satisfy imputation. Along the same lines, a BOC could offer a flat-rated toll

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49. *Non-Accounting Safeguards Order*, at 21984.

50. *See* Selwyn Declaration, August 5, 2002, at fn. 83.

service[51] that by itself does not satisfy the imputation requirement, so long as profits from other by-the-call services provide sufficient contribution above access charges so that these two service categories, in aggregate, satisfy imputation. Since imputed access charge "payments" do not actually "cost" the BOC anything above the incremental costs of the access services themselves, imputation rules *per se* are not sufficient to prevent a BOC from engaging in price squeeze tactics.

23. If BOCs are permitted to provide interLATA and local services on a fully integrated basis, they will not use "access services" at all, and will gain enormous competitive advantage over competing interLATA service providers. BOCs might then argue that any imputation requirement should be applied across all interexchange services (intraLATA and interLATA) in aggregate, creating the potential for inter-service cross-subsidization where the extent of actual competition differs from market to market. Additionally, the elimination of the separate affiliate requirement will make it all but impossible to actually track the costs that are being "assigned" to such competitive services, costs that are supposed to be added to the "imputed" access charges to determine whether the imputation requirement has been met.

24. The BOCs' core position here is that they should be permitted to operate their *competitive* businesses (interLATA toll) *incrementally* with respect to their core monopoly

51. Verizon New England offers its Massachusetts residential customers a flat-rated LATA-wide unlimited calling plan as well as optional extended calling plans to provide flat-rate calling to points that would otherwise be subject to toll charges; Verizon New Jersey offers "Selective Calling Service" whereby residential customers can obtain 20 hours of calling to specified ("selected") exchanges for a flat monthly charge.

local service business. Under this theory, the captive local service customer pays the entire cost of all jointly-used network facilities and organizational resources. We have already seen examples of this philosophy with respect to the attribution of "joint marketing" costs to the 272 affiliate, with only the small increment of time that the service representative spends dealing with long distance service being "charged" to the affiliate.[52] Competition under such conditions cannot be expected to survive for very long.

The BOCs have grossly exaggerated the costs of structural separation, and have offered no factual support whatsoever for the notion that such "costs" exceed the substantial public benefit that continued application of Section 272 would produce.

25. All of the BOCs claim that the Commission has previously determined that *nonstructural* safeguards are *always* preferable to structural separation as a means for protecting competition and competitors from anticompetitive BOC conduct, and contend that the Section 272(a) separate affiliate requirement is a short-term transitional policy that Congress assumed would be eliminated very quickly, specifically, at the end of three years following a BOC's receipt of Section 271(d) in-region interLATA authority in any one of its states.[53] They cite *Computer III*'s finding that "inefficiencies and other costs to the public associated with structural separation significantly outweigh the corresponding benefits" and on

52. As noted in Selwyn Declaration, August 5, 2002, at fn. 88-89, Verizon New York charges Verizon Long Distance $7.71 per customer contact, while SBC Telecom charges SBCLD $9.90 per customer acquisition.

53. Qwest Comments, at 5-6; SBC Comments, at 5; BellSouth Comments, at 19; Verizon Comments, at 9.

that basis contend that the separate affiliate requirements applicable to BOC in-region long distance service should be eliminated forthwith.[54] With respect to the statements in *Computer III* upon which the BOCs rely, it is my understanding that these have not been upheld on appeal.[55] Moreover — and this goes directly to the "cost/benefit" analysis — because of the enormous size of the long distance market (some $110-billion annually), the dollar magnitude of the potential competitive harm that can arise so vastly exceeds the harm that the BOCs could have inflicted in the *Computer III* context as to render the prior cost/benefit comparisons of no current relevance. In addition, the provision of many of the "competitive" services addressed by *Computer III* did not and do not involve the same kind of "bottleneck" services and facilities for which IXCs and CLECs are today utterly dependent. In the case of customer premises equipment ("CPE"), once the FCC adopted the Part 68 "equipment registration" program in 1977 and 1978,[56] the Radio Shacks, K-Marts, and thousands of other retail outlets could freely sell consumer CPE — and any number of business phone system providers could freely sell key systems and PBXs — without any

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54. *Id.*, citing *Amendment of Section 64.702 of the Commission's Rules and regulations (Third Computer Inquiry); and Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Thereof; Communications Protocols under Section 64.702 of the Commission's Rules and Regulations*, Report and Order, 104 FCC 2d 958, 986.

55. *California v. FCC*, 39 F.3d 919, 930 (9th Cir. 1994) (as in prior orders, "the FCC has similarly failed to provide support or explanation for some of its material conclusions regarding prevention of access discrimination," and thus its "cost-benefit analysis is flawed").

56. *Proposals for New or Revised Classes of Interstate and Foreign Message Toll Telephone Service (MTS) and Wide Area Telephone Service (WATS)*, Docket no. 19528, *Memorandum Opinion and Order*, Rel. June 20, 1977, 64 F.C.C.2d 1058; *Third Report and Order*, Rel. April 13, 1978, 67 F.C.C.2d 1255.

concerns as to their or their customers' ability to interconnect those products with the public telephone network. (Put simply, the CPE "bottleneck" problem was entirely solved by the simple adoption of the standard "RJ-11" plug and jack — and consumers and CPE providers don't even have to buy their RJ-11 jacks from the phone company, because the Commission had also deregulated another CPE-related bottleneck — inside wire).

26. Except for Verizon, which provides three short declarations consisting almost entirely of unsubstantiated opinion with no hard, quantitative facts, none of the BOCs offer any substantive evidence in support of their "inefficiencies" contention. The Fred Howard declaration (for Verizon) recites his estimate of the costs that Verizon Global Networks ("GNI") has incurred and will continue to incur in order to comply with the separate affiliate rules of Section 272. According to Mr. Howard, "GNI has incurred approximately $195 million in capital costs and $314 million in expenses, including depreciation on capital, from 1998 through 2002 to meet section 272 requirements."[57] He goes on to report that "GNI will incur an additional $550 million in expenses from 2003 to 2006 to continue to meet these requirements."[58] He claims that "[i]f the Commission's section 272 rules sunsetted in 2002, ... a conservative estimate of the savings that could be obtained over the 2003 through 2006 time period by re-integrating operations with the BOC where it was economically advantageous to do so is about $247 million."[59] Because his "expense" figures included

57. Verizon Comments, Declaration of Fred Howard at 1-2.

58. *Id.*

59. *Id.*

depreciation, there is some double-counting as between his "capital cost" and "expense" figures. Mr. Howard's analysis included switches and transmission facilities, administration, land and buildings, servers, computers and capitalized software, NOC, OSS, and laboratory test systems. For expenses, Mr. Howard included "outside contractors, such as those providing field technicians, that would normally have been staffed by BOC employees, staff and administrative employees, leased transmission facilities, OSS, network operations, NOC, back office functions and miscellaneous."[60] No supporting documentation in provided to back up the quantitative figures that Mr. Howard recites. It is unclear how he accounted for all of these things — since several of them include services that are being provided by the BOC under contract with its Section 272 affiliate (i.e., for which the BOC is itself an "outside contractor" to the affiliate).

27. SBC makes similar claims: "SBC estimates that integration of long distance and local operations for the Southwestern Bell [] region would result in savings of 50 percent for personnel in the network engineering, customer care, billing, and network operations departments."[61] As with Verizon's contentions, SBC offers no factual support, cost study, or other backup for the figures that it presents. Unlike Verizon, SBC does not even provide a Declarant to attest to its claims. On its face, SBC's contentions are ludicrous. First, "customer care" and "billing" are not even included within the OI&M restrictions, and in fact

60. *Id.*

61. SBC Comments, at 7.

SBCLD purchases these services from one or more of its BOCs.[62] There is no basis to expect that eliminating the OI&M "operate independently" requirement would produce any consequential savings in these areas. With respect to the "duplication" of personnel and network facilities that SBC claims the OI&M restriction imposes, SBCLD, like any nonaffiliated IXC, may purchase access services and, in certain cases, UNEs *under tariff* from one of the SBC BOCs; nothing in Section 272(b)(1) *requires* SBCLD to construct facilities or engage additional personnel where these functions can be provided by the BOC either as access services or, where permitted, as UNEs. Incredibly, SBC even suggests that elimination of the OI&M restrictions would produce savings in Human Resources, Regulatory, Legal and Accounting, when in fact SBCLD may, and I believe actually does, purchase these support services either from one or more SBC BOCs or from other SBC affiliates.[63] SBC's various claims as to the "costs" of structural separation or the "savings" that would arise if the requirement is allowed to sunset are simply not credible, and should be discounted by the Commission.

28. It is noteworthy that, while here advising this Commission that structural separation has created and will continue to engender extraordinary costs that would not exist in its absence, Verizon's August 12, 2002 10-Q filing with the Securities and Exchange Commission ("SEC") makes no mention of the $1-billion or so of cost about which Mr.

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62. http://www.sbc.com/PublicAffairs/PublicPolicy/Regulatory/affdoc/SWBTtoSBLDrev.doc accessed 8/23/02.

63. *Id.*

Howard testifies. However, that same *CEO-certified* 10-Q does disclose some $2-billion in costs through 2002 for "integrating systems, consolidating real estate and relocating employees," among others, stemming from the 2000 GTE-Bell Atlantic merger that formed what is now known as Verizon. The Company also disclosed that some $500-million out of that $2-billion total was spent "on advertising and other costs to establish the Verizon brand."[64] Yet that same 10-Q makes no reference to any of the alleged extraordinary costs that Verizon's Declarants ascribe to the Section 272 separate affiliate requirement or claim would be avoided by its sunset, despite the fact that, according to Verizon's Declarants here, the general order-of-magnitude of those costs is the same as that for the "integration" costs that Verizon has disclosed in its SEC filing. Moreover, while Verizon is here advising the FCC that the requirement to maintain separate affiliates imposes costs, its disclosure to the SEC suggests that *integration* of what had been separate enterprises engenders even greater cost.

29. Verizon makes the particularly remarkable claim that separate billing of local and long distance is a significant expense: "Verizon estimates that approximately $91 million of incremental billing expense could be avoided through 2006 if long distance charges were included as part of the BOC's bill for local and toll services."[65] The footnote states that "[t]his is based on the costs of publishing separate long distance affiliate pages in the

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64. Verizon August 12, 2002, 10-Q, at Note 2 "Merger Charges and other strategic actions."

65. Verizon Comments, at 10.

customer's bills for local exchange service minus the mark-up in the billing and collection contract."[66] No support is provided for this cost figure, but on its face it would certainly appear to be a gross exaggeration. For example, if one assumes an average of 10-million Verizon long distance customers over the seven-year period from 2000 through 2006, and assume that each monthly bill for each of those customers required one additional page (due to the separate affiliate billing requirement), then that would represent a total of 840-million "extra pages" of billing. Note that the principal addition here is the paper, because the same overall number of individual call-detail line items would still have to be printed whether separate affiliate or integrated billing is involved. Verizon uses two-sided printing for its billing to residential and small business customers, so the 840-million additional "pages" represent an average of 420-million extra sheets of paper. The "extra" page is a worst-case scenario, since the inclusion of the intraLATA and interLATA billing on a combined basis will often require more than one page anyway, so that in those cases the "separate" billing would not involve "publishing" any additional pages or using any additional paper. Additional postage would almost never be required. At $91-million, this would work out to about 21 cents per sheet of paper. Put another way, if one assumes, more realistically, an incremental cost of about 1/2 cent per sheet of paper, the "additional cost" of separate affiliate billing over those seven years would more likely be in the range of about $2.1-million, or about $300,000 per year. In suggesting that its estimate is net of the "mark-up in the billing and collection contract," Verizon is perhaps attempting to portray this figure as some sort of "incremental" cost. In fact, Verizon has provided no information as to what this

66. *Id.*, footnote 7.

"mark-up" is or how it is computed. Certainly, and at the very least, if the Commission is to find any of Verizon's or SBC's quantifications to be dispositive of its ultimate ruling, it should give weight to the fact that none of these alleged "costs" has been disclosed or even referenced in the BOCs' 10-Q SEC filings, and should in any event require far more detail and far more factual support for all such figures.

As long as BOC prices for switched and special access services remain at multiples of cost, the BOCs retain the ability to discriminate against nonaffiliated carriers and engage in anticompetitive price squeezes with respect to the rivals' services.

30. As the Commission is well aware, switched access prices – both under rate-of-return regulation and subsequently under price caps – were set without regard to underlying costs, and are even today set at multiples of the incremental cost to the BOC of providing switched access service. The anticompetitive consequences of setting switched access prices above cost have been explicitly — and recently — recognized by the FCC in its *CALLS Order*:[67]

> Finally, the reduction in switched access usage charges will promote competition in the long-distance market between BOC affiliates entering this market and IXCs. To the extent switched access usage charges paid by IXCs are significantly above cost, BOC affiliates would have a competitive advantage because they would obtain switching services from the BOCs at cost. By driving switched access usage charges closer to their actual costs more quickly than

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67. *In the Matter of Access Charge Reform*, CC Docket No, 96-263; *Price Caps Performance Review for Local Exchange Carriers*, CC Docket No. 94-1; *Low-Volume Long Distance Users*, CC Docket No. 99-249; *Federal-State Joint Board On Universal Service*, CC Docket No. 96-45, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1; Report and Order in CC Docket No. 99-249; Eleventh Report and Order in CC Docket No. 96-45, Rel. May 31, 2000, 15 FCC Rcd 12962; 2000 FCC LEXIS 2807 ("*CALLS Order*").

> would occur under the existing price cap regime, the CALLS Proposal will minimize the competitive advantages BOC affiliates would have over IXCs in offering long-distance services while switched access rates were significantly above cost.[68]

Although some progress has been made through access charge reform and other initiatives to bring access charges "closer to cost," the objective of aligning switched access rates with costs has never been achieved — and cost/price disparities extant in intrastate tariffs are in many cases even greater than those applicable to *interstate* access charges.[69]

31. Under integrated operation, the BOCs would be able to double the competitive advantage they have over competitors by (1) avoiding using "access services" *per se*, while (2) continuing to apply excessive prices to the access services that competing nonaffiliated IXCs are forced to use. Specifically, when an IXC provides toll service to a BOC customer, the interexchange carrier must purchase switched access from the BOC in order to originate and/or terminate the call and incur additional network, administration (including billing and collection) and marketing costs in order to provide a "retail" long distance service to its end-

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68. *Id.*, at para. 158.

69. For example, in New Jersey, the per-minute intrastate interLATA switched access rate can be as high as $0.0337 at each of the originating and terminating ends of a call (*See*, Bell Atlantic New Jersey, Tariff BPU-NJ No. 2, Access Service Tariff, Section 3.8, Fifth Revised Page 15; Section 6.8.2(A)(3), First Revised Page 104; Section 6.8.2(C)(3), Original Page 104.1; Section 6.8.3(A), Sixth Revised Page 108 (all effective October 1, 1999 (Interim)). In New York, the per-minute intrastate interLATA switched access rate during the weekday rate period is $0.0290 at each end (*See*, Verizon New York, PSC NY No. 11 - Communications, Access Service, Section 30.3, Original Page 1; Section 30.6.1(A)(4)(a), Original Page 5; Section 30.6.1(C)(2)(c), Original Page 22; Section 30.6.2(A), Original Page 28; Section 30.14, Original Page 66 (all effective September 1, 2001)).

user customers. When a BOC provides retail toll services to one of its end-user customers, the BOC accomplishes precisely the same functions of call origination and call termination that are provided to IXCs in the form of switched access services, but because the BOC is able to integrate these "access" functions with the interexchange switching and transport functions associated with the interexchange portion of the call, its actual out-of-pocket costs are frequently even lower than the "cost" the BOC incurs in providing switched access services to IXCs, and immensely lower than the "price" that those IXCs pay to the BOC for switched access services. From the perspective of the competing long distance provider, access charges are an actual cash out-of-pocket cost, whereas from the perspective of a BOC, any "imputation" of equivalent access charge payments amounts to little more than moving money from one "pocket" to another. As I noted in my August 5 Declaration, the BOCs' own economic experts have concluded that BOCs are "profit-maximizing" with respect to access and retail long distance services *combined*, ignoring entirely any "access charge imputation" requirement.[70]

32. As long as the BOCs are required to provide long distance services through an affiliate that operates independently of and at "arm's length" with respect to their local exchange operations, those affiliates will need to purchase BOC access services in exactly the same form as they are provided to nonaffiliated IXCs, out of the same interstate and intrastate access tariffs, and at exactly the same prices and under exactly the same terms and conditions.

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70. The BOCs' use of "double marginalization" as a pricing strategy, i.e., profit-maximization across the access and interexchange network functions combined, is discussed at para. 49 *et seq.* of my August 5, 2002 Declaration.

If the Commission were to determine that, notwithstanding the "operate independently" and "arm's length" requirements of Section 272(b), the BOCs and their long distance affiliates were *in fact* engaged in the type of "double marginalization" pricing that Hausman *et al* have described, it would be in a position to take corrective action and in so doing minimize the potential for a BOC-imposed price squeeze upon rival firms. However, if the Commission were to end the requirement that the BOC operate its in-region long distance business out of a separate affiliate, and were no longer to require that the BOC long distance business activity operate independently with respect to, and transact all business at arm's length with, the BOC's local exchange operations, the BOC will be then capable of engaging in "double marginalization" pricing and in imposing a price squeeze with respect to access charges and retail long distance rates. The BOC will no longer utilize or pay for its own switched access service *per se*, even though it will be providing the corresponding functionality *for itself* to originate and terminate such calls at its local subscribers' access lines. The BOCs will have thereby obtained a unique competitive advantage that is not available to any competing IXC. Put differently, while the interexchange carriers' profit margin is the difference between the retail long distance service price and *all* of its costs, including the out-of-pocket switched access payments it makes to a BOC, a BOC's profit margin will be the difference between the retail toll price and the BOC's *actual cost* of providing the switched access functionality to itself as part of its retail toll service. The BOC alone has the ability to reap *additional* profits equal to the difference between the cost and retail rate for switched access functionality.

33. Even with the 2001 *CALLS* reductions in switched access charges, BOC access rates are still set at large multiples of cost. The magnitude of the excess of price relative to cost for access services can be roughly estimated by comparing BOC switched access rates with the *TELRIC*-based rates for the same functions when provided as unbundled network elements ("UNEs") that are offered to CLECs for use with their *local* services as required by Sections 251 and 252 of the 1996 *Act*. The *functions* that are involved in providing switched access are *identical* in every material respect to the functions associated with *local switching, tandem switching* and *common transport* that are provided by the BOCs as UNEs at rates that have been determined to be cost-based. For example, even after the *CALLS* access charge reductions, the current price of switched access – roughly $0.0055 per minute at each end of a call[71] – is still nearly eight times the $0.0007 (per end) federal cap on local reciprocal compensation call termination rates as set by the FCC in the *ISP Remand Order*.[72] And, in many states, the gap between in-state access prices and cost for the same local switching and transport functions is even greater.[73]

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71. *CALLS Order*, at **355.

72. *Implementation of the Local Competition Provisions in the Telecommunications Act of 996; Intercarrier Compensation for ISP-Bound Traffic*, CC Docket No. 96-98; CC Docket No. 99-68, *Order on Remand and Report and Order*, Rel. April 27, 2001, 16 FCC Rcd 9151, 9156.

73. For example, in New York, the first state to obtain Section 271 authority, the current *intrastate* interLATA switched access rate during the weekday daytime rate period is $0.0290 per minute. *Supra*, footnote 69. Thus, Verizon's intrastate access charge in New York may as much as 41 times the $0.0007 per-minute local call termination rate cap established by the FCC in the *ISP Remand Order*.

34. If the tariffed rates for switched access services (as they apply to IXCs) are set at any level *above* the actual cost of providing the service, and assuming that market conditions forced competitors' long distance prices to be set at levels *no greater than* those being charged by the BOCs, competitors will face higher costs than the BOC, and will thus be forced to deal with a decidedly lower — or even a *negative* — profit margin. Thus, the existence of switched access rates at levels substantially above cost permits the BOCs to implement an anticompetitive price squeeze against other toll providers that will ultimately squelch non-ILEC competition for long distance services.

35. There is another related point that should also be addressed. Most of the BOCs argue that the Commission should not be concerned about anticompetitive conduct and cost shifting because the price cap regime extant in the federal arena and in most states does not permit a carrier to increase its prices or revenues (for its regulated services) as a result of cost misallocation. As a result, they claim, the BOCs have no incentive to engage in anti-competitive conduct.[74] In fact, precisely the opposite may be the case. Under rate of return regulation, if the BOC sets the price of an essential service (that is subject to the Section 272(e)(3) imputation requirement) above cost, then its own "imputation payments" would be included in determining the appropriate price level for the remainder of its regulated services. Thus, if the BOC were to set an excessive price, the excess profits resulting from imputation payments would have to be flowed through to its basic service ratepayers in the form of lower prices for other (retail) services. By contrast, under price caps, the BOC has no such

74. Verizon Comments, at 18; SBC Comments, at 10-12; Qwest Comments, at 13.

requirement: It can overcharge its own competitive business unit without being forced to flow-through the excess profits resulting from this strategy; in effect, it will simply be shifting profits from one "pocket" into another. And in other situations, where the inter-affiliate transfer price is not used to establish the cash price that nonaffiliated carriers would pay the BOC for like services (e.g., because the BOC does not provide "like services" to the nonaffiliated carrier — joint marketing services, legal and lobbying services, are good examples), the BOC can *underprice* the services it provides to its affiliate, effectively negating the *overcharge* that it had applied where the transfer price matters (i.e., where it is used as a basis for the cash price that nonaffiliated carriers pay for an essential service). The point is that under "pure" price caps, where the BOC is not subject to any cap on earnings or any obligation to share excess earnings, payments for inter-affiliate transfers have no economic or financial consequence for the corporation as a whole, they amount to shifting money from one pocket to another. And, of course, if the separate affiliate requirement is allowed to sunset, the BOCs will no longer be under any obligation to post or otherwise make public — or for that matter even use — any "transfer prices" applicable to services furnished by the BOC to its (integrated) long distance business activity.

36. Despite SBC's joining in advancing this same "price cap" theory, SBC does admit that it

> does not disagree with the Commission's conclusion in the *Interconnection Order* that there may be forms of discrimination that are imperceptible to end users. ... However, such types of discrimination would not lead to the acquisi-

> tion of market power. Only discrimination that affects the purchasing decisions of large numbers of customers could confer market power.[75]

But that is precisely what would happen if a BOC were to raise the price of an essential facility to supracompetitive levels. Competing IXCs would be forced to increase their own retail prices, permitting the BOC's long distance business unit to either impose a price squeeze on its rivals or, alternatively, to raise its own retail prices as well. SBC's tactic would in fact "affect[] the purchasing decisions of large numbers of customers" and in so doing would "confer market power." Price caps provides BOCs with both a strong incentive and the capability to set prices of essential facilities far in excess of cost, whether or not they are required to "impute" those prices into the retail prices of their own competitive services (e.g., long distance).

37. All of these circumstances, taken together, lead to one inescapable conclusion: Competition for long distance services cannot be assured if the BOCs are permitted to operate on an integrated basis while at the same time extracting economic rents for access services furnished competitors at above-cost prices. Lowering switched access prices to cost-based levels will assure that incumbent LECs and competitive interexchange carriers face identical costs for the underlying wholesale service of providing the first- and last-mile connection between the calling party and the called party, and will thus enhance the opportunity for the development of a competitive market for interLATA toll services. Before the Commission gives any serious consideration to ending the Section 272 separate affiliate requirement for

75. SBC Comments, at 11.

BOC toll services, the Commission should require that all BOCs first set their access charges on the same basis as UNE rates — i.e., at TELRIC levels.

Conclusion

38. Section 272 was inserted into the 1996 *Act* specifically out of concern that a BOC, having reentered the long distance market, would be capable of using its market power in the *local* services market to diminish competition in the adjacent long distance market. Although the BOCs cite to the small losses in market shares that they have sustained over the past six years, those losses do not translate into any substantive diminution of the BOCs' market power. That *fact*, coupled with the BOCs' ability to set access charges at supracompetitive levels well in excess of cost, provides sufficient basis for the Commission to extend the sunset date for the Section 272 separate affiliate requirement.

The foregoing statements are true and correct to the best of my knowledge, information and belief.

LEE L. SELWYN